84-612

No. ____________

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1984

JAMES W. YARBRO and MARY E. YARBRO, *Petitioners*

vs.

COMMISSIONER OF INTERNAL REVENUE SERVICE, *Respondent*

Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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QUESTIONS PRESENTED

1. Whether the abandonment in 1976 of unimproved land, which was subject to a nonrecourse purchase money mortgage not included in petitioner's basis, and which was foreclosed by mortgagees in 1977, was a "sale or exchange."

2. Whether the abandoned land which was acquired initially as farm rental property, until conditions were favorable for urban development, but which was used solely for the production of taxable rental income during the entire period held by petitioner, was property used in a trade or business.

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Respondent

PETITION FOR
WRIT OF CERTIORARI
TO THE
FIFTH CIRCUIT
COURT OF APPEALS

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

JAMES W. YARBRO and MARY E. YARBRO, the petitioners herein, pray that a writ of certiorari issue to review the judgment of the United States Court of

Appeals for the Fifth Circuit entered in the above-entitled case on July 30, 1984.

OPINIONS BELOW

The opinion and decision of the United States Tax Court is printed in Appendix A.

The opinion and judgment of the United States Court of Appeals for the Fifth Circuit is printed in Appendix B.

The denial by the United States Court of Appeals for the Fifth Circuit on Suggestion for Rehearing En Banc is printed in Appendix C.

The stay of mandate by the United States Court of Appeals for the Fifth Circuit is printed in Appendix D.

JURISDICTION

The United States Court of Appeals for the Fifth Circuit entered judgment on July 30, 1984, and denied a petition for rehearing on August 30, 1984. The jurisdiction of the Supreme Court is believed

to be invoked under 28 USCS #1254 (1).

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code

Section 165. Losses.

(a) General rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or exchange of property.

(c) Limitation on losses of individuals. In the case of an individual, the deduction under section (a) shall be limited to

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business ...

(f) Capital losses. Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

Section 266. Carrying charges.

No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as under regulations prescribed by the Secretary, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes and charges as so chargeable.

Section 1001. Determination of amount of gain or loss.

(a) ...the loss shall be the excess of the adjusted basis provided in (section 1011) for determining loss over the amount realized.

(b) The amount realized from the sale or other disposition of property shall be the sum of any money received plus the value of the property (other than money) received.

Section 1002 (1976). Recognition of gain or loss.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

Section 1011. Adjusted basis for determining gain or loss.

(a) The adjusted basis for determining gain or loss from the sale or other disposition of property ... shall be the basis (determined under section 1012 ...) adjusted as provided in section 1016 (inapplicable here).

Section 1012. Basis of property - cost.

The basis of property shall be the cost of such property.

Section 1221. Capital asset defined.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business) but does not include:

(2) ... real property used in his trade or business; ...

Section 1222. Other terms relating to capital gains and losses.

For purposes of this subtitle -

(4) The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than one year ...

REGULATIONS

Section 1.165-2 provides:

(a) Allowance of deduction. A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually

sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) Exceptions. This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

Section 1.266-1. Taxes and carrying charges chargeable to capital account and treated as capital items.

(a) In general. In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of subtitle A of the Code. No deduction is allowable for any items so treated.

(b)(1) The taxpayer may elect, as provided in paragraph (c) of this section to treat the items enumerated in

this subparagraph which are otherwise expressly deductible under the provisions of subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are -

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

Section 1.1001-2. Discharge of liabilities -

(a) Inclusion in amount realized -
(1) In general. Except as provided in paragraph (a)(2) (inapplicable here) and (3) of this section, the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(3) Liability incurred on acquisition. In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

STATEMENT OF CASE

Petitioner, acting collectively for himself and others, purchased in his name a tract of farm land (then subject to a year-to-year farm and ranch lease) on the outskirts of Fort Worth, Texas on November 15, 1972. The land was zoned agricultural on county and city tax rolls and was continuously rented to an adjoining landowner for that purpose during the entire time held by petitioner.

The property was acquired for a down payment of 10% of the agreed price, deferred annual payments of 5% at the end of the 8th through the 11th years, and 70% at the end of the 12th year, plus 7% interest. Petitioner had the option of abandoning all ownership rights to the property at any time without recourse or liability of any kind. Consistent therewith, he did not record the 90% deferred purchase price on his books of account nor

include it in his basis for the property.

Plans for the land were to continue to lease it as farm land until prospects for urban development were favorable, or otherwise sell or abandon it, depending on circumstances then existing. If development had become feasible, one of the participants, who owned 50% of the land and was a major Dallas builder and developer, would have guided this phase of the activity. The petitioner and the four other co-owners were successful business and professional people who had the unquestioned financial ability to make all principal and interest payments under the purchase contract and, when and if economically feasible, to convert the property to urban use. No attempts were ever made to sell the land.

The rental income received from the property more than covered property taxes and liability insurance premiums. Interest

paid was not an expense of operation but a carrying charge on the optional deferred purchase payments (see Code section 266 and regulations thereunder authorizing the optional capitalization of interest on a loan to purchase property).

All taxes and contractual obligations under the purchase agreement were timely paid and no condition of default existed prior to November 15, 1976. Because of adverse economic changes which lowered land values in the area well below the deferred purchase price, combined with a contemporaneous quadrupling of Fort Worth property taxes, petitioner opted at that time to abandon the property and so notified the trustee for the mortgagees. From that date, neither petitioner nor any co-owner had any contact with the property, the tenant, or the mortgagees. Legal title, however, remained in petitioner's name until mortgagees reacquired title

through a foreclosure sale in mid-1977.

In the light of subsequent events, if petitioner had not given notice of abandonment in 1976 and merely allowed the mortgage to lapse into default for nonpayment of taxes and interest, no loss would have occurred in 1976, and a loss would have been realized in 1977 when the foreclosure sale occurred. It is conceivable, however, that he could have renegotiated the mortgage debt downward some 50% in light of the fact that the mortgagees resold the property a few months after foreclosure for less than 50% of the unpaid purchase price. Such was not the case here, of course, but it serves to illustrate that the abandonment was not (as the Court of Appeals suggests) an artfully timed manipulation to frustrate tax rules or congressional purposes. The inference that petitioner manipulated the character of his loss by hastening to abandon rather

than allowing foreclosure to take its course is unfounded and inappropriate under the facts here. Such a charge was never asserted by respondent in the pretrial development of stipulated facts.

The decision to abandon was one of several options petitioner could have chosen: continue to hold the property, pay interest and taxes, and ride out the recession; attempt to renegotiate more favorable terms with the mortgagees such as reduced principal and higher interest in line with changed economics; let the mortgage lapse into default and thus bring pressure on the mortgagees to adjust the mortgage to current values; or resolutely abandon the property.

Economics ruled out the first-named option, but it was a matter of personal self-respect and integrity that abandonment was decided upon in preference to the other options; and it was not dreamed in

1976 that the Commissioner would not, also in good faith, continue to honor his undeviating historical treatment of abandonment losses unless he were forced to do so by legislative enactment. That the Tax Court could tempt him to make so drastic a reversal of a locked-in position was equally unthinkable.

In that context petitioner confidently took an abandonment loss deduction on his 1976 tax return in the amount of his $10,376 cash investment in the property.

In 1978 that return was selected for an intensive field audit by respondent's revenue agent, Beverly Lang, who found no errors and accepted the return as filed after carefully inquiring into the abandonment loss deduction. The entire transaction was fully explained and supported, and a no-change report was filed. It was returned by respondent's review section for reclassification of the abandonment

loss to a long-term capital loss. A conference was then held with the examiner's group chief who disapproved the review section's recommendation and authorized the resubmission of the no-change report, but it was again returned with direct orders to make the change recommended by review. This was done resulting in a proposed deficiency of $2,888.89.

A district conference was requested, reluctantly granted and perfunctorily concluded without any concessions. An appellate conference was then sought, heard by Ken Jaggers, and concluded with tentative acceptance of petitioner's position subject to Mr. Jagger's independent review and research. Many weeks later he called petitioner to advise apologetically that, although he had found no error in petitioner's position, an arbitrary policy decision had been made to uphold the proposed deficiency without disclosing any basis

therefor.

Statutory notice of the deficiency then followed on April 19, 1979. A petition was then filed with the Tax Court. On November 30, 1980, before the case was called for trial, respondent's trial attorney, W. B. Lowrance, offered a compromise settlement which was accepted by petitioner, and the trial judge removed the case from the docket.

Some nine months later the petitioner received a notice from the Tax Court that the case had been restored to the docket for trial on October 6, 1981. Petitioner tried to contact Mr. Lowrance to find out what had happened to the settlement and was told that it had been withdrawn by Mr. Lowrance's superiors and that Mr. Lowrance had been transferred to an overseas post of duty. W. B. Riley, Regional Counsel, apologized for what had happened but offered no explanation.

The United States Tax Court is a Court of original jurisdiction in federal tax disputes, and its jurisdiction is believed to be invoked under 28 USCS #1254 (1).

Trial was held, briefs were filed, and a memorandum decision was entered for respondent on November 22, 1982. The decision was appealed to the Court of Appeals for the Fifth Circuit, oral arguments were heard on November 30, 1983, and the Tax Court decision was affirmed on July 30, 1984. A stay of mandate was requested and granted for filing of a petition for writ of certiorari with the United States Supreme Court by October 17, 1984.

REASONS FOR GRANTING WRIT

This petition presents a question of law concerning the authority of the respondent to make a determination that:

1. conflicts with his own regulations;

2. conflicts with a principle of law he had consistently followed throughout

the history of the tax law and unhesitatingly conceded before the Tax Court some two years after the determination here; and

3. conflicts with decisions of several Courts of Appeal and this Court. [In the interest of brevity, court cases discussed herein are mentioned by name only for the most part. Citations are included, of course, on the Table of Authorities (page iii)].

Furthermore, the record of this proceding, from the revenue agent's initial report through the administrative conferences and judicial review [see Statement of the Case herein], reveals a pattern of events suggestive of a covert plan to "correct" a perceived inequity in the tax law (pertaining to abandonments) by judicial rethinking without deferring to Congress and awaiting lengthy and cumbersome legislative action which might never come,

and if it did, would apply prospectively.

Whether or not there is credence or substance to the circumstantial appearance of collusive improprieties in this proceeding, even the appearance of wrongdoing by the Treasury Department or the courts can be an Achilles heel to the tax system and should not be condoned or tolerated. The doctrine of stare decisis should be invoked in any event.

I

Reg. 1.165-2

This regulation recognizes an ordinary deduction under Code section 165(a) for a loss arising from the sudden termination of the usefulness, or permanent discarding, of nondepreciable property held for profit or used in a business. The loss is deductible in the year sustained. If the disposition of such property is by a sale or exchange, it is governed by subchapter O and not 165(a). If such property is

abandoned, the year the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or loss of title, occurs.

The respondent's announced position on this section has never intimated that a transaction could be both an abandonment and a sale or exchange.

In Freeland, the Tax Court inferred that a quitclaim deed to the mortgagee constituted an "abandonment" under California law. Since a reassignment of title to the mortgagee has been determined to be a sale by the courts (unless a true abandonment prior thereto was proven), the transfer of property by quitclaim deed is a sale. Thus, a so-called California abandonment, effected by quitclaim deed, is in reality a sale, if the Tax Court's construction of California law is correct. The Commissioner flatly conceded in that case "that an abandonment of property is

not a disposition by sale or exchange." [Freeland, 74 T.C. at 974].

One year later, in Middleton involving a similar transaction in another state, the Commissioner "abandoned" his Freeland concession and contended there that no abandonment preceded the foreclosure action, but if it did, then such abandonment was also a sale. The Tax Court quickly accepted the alternative contention, and said (regarding the Commissioner's primary contention that the taxpayer's offer to reassign title to mortgagee, thus avoiding a foreclosure sale, was not a disposition by abandonment) in Middleton:

> We believe, however, that (taxpayer) effectively abandoned the property...

The Tax Court below then used its Freeland-Middleton logic to justify its finding here that abandonment by petitioner was also a sale (without comment

on the differences in the factual situations).

The Court of Appeals, however, took pains to divert attention from the clear meaning of Reg. 1.165-2 by its references to "proper _timing_ of the deduction" and "not the _character_ of the loss." And it avoided any reference to the Commissioner's statement in _Middleton_ which effectively confirmed what Regulation 1.165-2 says. This is an error that this Court should address.

Reg. 1.1001-2

This regulation deals with the realization of income from discharge of liabilities upon sale or other disposition (e.g., abandonment) of property. [This Court dealt with this subject in its recent _Tufts_ decision.] This section is basic to the following statement by the Tax Court in _Freeland_:

> We believe that the holdings of _Crane_ ... mandate the conclusion that

> relief from indebtedness ... is sufficient to support a sale or exchange.

The "relief from indebtedness" concept of the Crane holding does not apply here, however, because the unpaid nonrecourse purchase money was never included in petitioner's basis. Regulation 1.1001-2(a)(3) provides:

> In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

This is another error this Court should address.

II

Principle of Law

The historical treatment of abandonments by the Commissioner is clear and undeniable (before the 1981 Middleton decision). In its opinion below, the Court of Appeals said [page B-26 of appendix]:

> Allowing taxpayers to manipulate the character of their losses from capital to ordinary by hastening to abandon rather than allowing foreclosure would frustrate the Congressional purpose to treat capital gains and losses on a parity. As explained by the Supreme Court in _Hammel_, the _quid pro quo_ of allowing generous tax treatment on capital gains is the limitation imposed on deductions for capital losses. Thus, where the taxpayer would be eligible for capital gains treatment upon the sale of property had it appreciated in value, he should not be allowed to avoid the limitations on deductions for capital losses by using an artfully timed abandonment rather than a sale, voluntary reconveyance, or foreclosure. Accordingly, we affirm the Tax Court's holding that the Commissioner's interpretation of "sale or exchange" as including an abandonment of property subject to nonrecourse debt is a reasonable one.

The quoted statement is fraught with unjustified disparagement, misstatements and illogical reasoning. "Manipulation," and "artfully timed abandonment" imply deviousness which is completely refuted by the facts. Petitioner was not _forced_ to abandon the property. He and his associates had the unquestioned financial re-

sources to complete the purchase and the necessary business acumen and experience to convert the property to a better use if feasible. The purchase contract was not in default at any time prior to giving notice of abandonment. Thus, mortgagees could not assert (prior to the abandonment) any claim to the property. Petitioner, acting for himself and his associates, made a choice and exercised the first of three options: (1) abandon the property and the contract; (2) default on the contract to gain time and leverage in possibly renegotiating the contract; or (3) continue holding the property and honoring the purchase contract. To conjecture what the consequences of an alternate choice would have been, is academic; but one thing is certain: petitioner chose not to pursue any option other than a classic abandonment (as contemplated by Reg. 1.165-2) and was

forever bound to that choice. Petitioner contends that the courts should have no power to abrogate his choice of options permitted under the law or by regulations. But they surely will unless this Court decides to grant this petition.

The existence and exercise of taxpayer options under the tax laws are not new, accidental, immoral or unfair (if they are authorized by the law, the regulations or the Commissioner's policy rules and practices). When Congress passes a law that contains unintended results (favoring either the taxpayer or the government), it routinely enacts corrective legislation. It is not the intended province of the courts to superimpose their views on what the law should be. An option in point is the intangible drilling and development expense option originally provided only by the Commissioner's regulations but later codified by Congress in

order to dispel doubts about validity.

The reference to "Congressional purpose" in the quotation above is misleading. Gains and losses from the sale of business assets are lumped together and treated as a capital gain (if a net gain) or an ordinary loss (if a net loss) [Code section 1231]. In the case of stocks and bonds, sales frequently can be timed to make them short-term or long-term, as the seller prefers, without "frustrating Congressional purpose" [Code sections 1202, 1211 and 1222]. The situation is no different here, the Fifth Circuit opinion below notwithstanding.

The reference to the "Commissioner's interpretation" of "sale or exchange" is ironic in the light of his historical view on abandonments as conceded in Freeland. It was in truth the Tax Court's interpretation which the Freeland court effectively forced on the Commissioner. [These

are departures from the accepted and usual course of judicial proceedings which this Court should address.]

The Hoffman Conflict

The point case on abandonment losses is the 1939 Hoffman decision of the Board of Tax Appeals which was affirmed by the Second Circuit in 1941. An acquiescence by the Commissioner was entered in 1951 (and his earlier nonacquiescence withdrawn).

The facts here comport in all material respects with the Hoffman facts, and petitioner contends that Hoffman controls here just as it did in all abandonment cases for forty years before Middleton challenged it.

The Middleton opinion said that the Tax Court would no longer follow Hoffman because it preceded Crane and because:

> In Hoffman, the Board found, without discussion or analysis, that the

> taxpayers-mortgagors sustained an ordinary loss as a result of the abandonment (and) ... the Second Circuit <u>merely</u> affirmed... The question of whether a sale or exchange, rather than a mere disposition, might have occurred by reason of abandonment of property subject to nonrecourse debt was never considered in <u>Hoffman</u>.

The arrogance of that pronouncement is underscored by these facts:

(1) The comprehensive, carefully reviewed and well reasoned decision of the <u>Hoffman</u> court.

(2) The sentence therein:

> Another court said that a <u>sale</u> is unnecessary in establishing a loss where value has become extinct and there is no variable to determine. [Emphasis added.]

(3) The second sentence of the opinion:

> Although respondent is willing to concede a capital loss in 1935, when title was lost (by foreclosure sale), he contends that there can be no loss from the ownership of real estate while title was retained.

(4) The statement in <u>Denman v. Brumback</u> [cited in <u>Hoffman</u>]:

> Undoubtedly a sale of property is an identifiable event, more conclusive, perhaps, than anything else could be. This is not to say, however, that in the case of real estate it is the only possible identifiable event which can fix and determine a loss.

(5) Although Crane was decided after Hoffman, it involved a negotiated sale--not an abandonment in any sense--and thus has no bearing on the Hoffman decision; and it should be noted that the Commissioner filed his acquiescence to Hoffman four years after Crane.

If the Middleton thrust is not parried by the Supreme Court (which it now has the opportunity to do by granting this petition), the door will be opened to even further abuses of executive and judicial power, leading to an emasculation of the law.

Other Cases

Bickerstaff v. Commissioner, CA-5, 128 F.2d 366 (1942), was among the Hoffman line of cases distinguished by the same

Court of Appeals in its opinion below because "the issue was not whether an abandonment is a 'sale or exchange' for determining whether the loss is capital or ordinary." [Page B-13 of the Appendix.]

In Bickerstaff, the Fifth Circuit said:

> A definitive sale of property is not required, and even in the absence of a divestiture of legal title a taxpayer may be considered in a very practical sense to have abandoned real estate.

The Court of Appeals below also distinguished the case of Blum v. Commissioner, 133 F.2d 447 (2d Cir. 1943) with this statement:

> Blum held that the transaction in question was indeed a sale and not an abandonment, and concluded there was a capital loss.

The facts there were that taxpayer told his attorney that he wanted to abandon property he considered worthless, but the attorney persuaded him to sell the property to a third party for $250. The

appellate court accepted the trial court's findings that the suggested abandonment was aborted so that the property could be sold instead:

> It is argued with some plausibility that before the transfer was effected the petitioner's equity in the mortgaged property had become worthless, he had decided to abandon it and that in Commissioner v. Hoffman we had allowed a deduction of an ordinary loss under circumstances much like the present... It is hard to say that Blum abandoned the property prior to the transfer... Instead of surrendering his equity to the bank, he preferred to get $250 out of it... We hold that there was no abandonment prior to sale.

The opinion below went on to cite Commissioner v. Green, 126 F.2d 70 (3d Cir. 1941) and Helvering v. Jones, 120 F.2d 828 (8th Cir. 1941), saying:

> The courts seem to assume that an abandonment was not a "sale or exchange," but nevertheless held that the loss was a capital loss because the taxpayers' interests in the property were not cut off until the later foreclosure sales, which themselves are "sales or exchanges." Helvering v. Hammel.

The Green opinion distinguished Hoff-

mann because there:

> ... the taxpayers' interest in the property had become entirely worthless in the year when they abandoned it and so advised the mortgagee. But, furthermore, and of first importance, the taxpayers in the Hoffman case had not assumed liability for the mortgage to which their property was subject. In such circumstances, the definitive event which cuts off the taxpayers' interest in a property does not necessarily depend upon the foreclosure sale. Nor, more particularly, does the foreclosure sale then serve as a means for determining the amount of any deficiency judgment against the surrendering owners. The fact in the Hoffman case that there was no mortgage liability on the part of the surrendering taxpayers was of fundamental importance to the decision in that case.

The Jones opinion stated:

> If loss of taxpayer, whose equity in Missouri realty was wiped out by mortgage foreclosure sale, was suffered by reason of the foreclosure, then it was a "capital loss" which in computing taxable income was allowable only to the extent of $2,000 as limited by the statute (Revenue Act of 1934); but, if it was a loss sustained during taxable years resulting from a change in business conditions, then it was an "ordinary loss" which was allowable in full in computing taxable income.

Because of these errors by the court

below which ought to be reviewed, this Court is urged to grant this petition.

Tufts Distinguished

In 1983, this Court decided Commissioner v. Tufts, 103 S.Ct. 1826, and ruled that because Tufts was entitled to, and did, include the amount of a nonrecourse loan in computing the basis of property upon which depreciation deductions were claimed, the unpaid balance of the loan assumed by the purchaser when the property was later sold must also be included in the amount realized from the sale.

The Court of Appeals below interpreted Tufts to support the Commissioner's position here that petitioner's "amount realized" from his abandonment was, in effect, $65,174 representing his 20% of the $325,871 deferred purchase price. Since petitioner did not include deferred payments in his basis of $10,376 (repre-

senting money he actually invested), this would indicate that petitioner received a gain of $54,798, which is absurd, of course, and which the Commissioner did not assert in his statutory notice. The notice reclassified the loss of $10,376, claimed on the return as an ordinary loss, to a long-term capital loss.

Tufts does not apply here for several reasons:

(1) The transaction involved in Tufts was a sale, whereas the transaction here was an abandonment.

(2) The deferred nonrecourse purchase money loan was not included in petitioner's basis.

(3) No depreciation or amortization was involved here.

(4) In Tufts, title was transferred to, and the nonrecourse debt was assumed by, the purchaser.

Here, title was not transferred, and

the nonrecourse debt was simply forgotten and not assumed by anyone. It was, of course, legally dissolved later along with title in the foreclosure proceedings. Relief was neither sought nor realized. The debt vanished with the winds of abandonment, the same as accrued taxes and interest, because there was no personal liability involved. Furthermore, no deduction was ever claimed with respect to these items.

The Hammel Decision

The opinion below misconstrues the thrust of this Court's Hammel opinion. In a well reasoned opinion, Hammel overruled lower courts on their determination that a sale must be voluntarily entered into by the seller to be a sale. After carefully reviewing the legislative history, Hammel concluded that Congress had not intended to restrict the ordinary meaning of sale; therefore, a sale is a

sale. It is no way suggested that a transaction other than a sale could be a sale. The opinion began:

> It is not denied that it was the foreclosure sale of respondents' interest in the land purchased by the syndicate for profit, which finally liquidated the capital investment made by its members and fixed the precise amount of the loss which respondents seek to deduct from gross income.

Thus it is distinguishable from Hoffman and the case at hand where property was clearly abandoned and the loss sustained at that point and not at a later date when the property was repossessed.

The Flaccus Decision

On the heels of Hammel this Court continued its Hammel analysis on the statutory meaning of sale or exchange in its review of William Flaccus Oak Leather Co., 313 U.S. 247, and concluded that the term could not be extended by the courts to a transaction that was neither a sale nor exchange, such as "the demolition of

property and subsequent compensation for its loss by an insurance company." This Court said:

> ... Congress has chosen a particular method of classifying as sales or exchanges transactions which would not ordinarily be described by one of those terms (citing specific enactments).
>
> ... These sections demonstrate that Congress has expressly specified the ambiguous transactions which are to be regarded as sales or exchanges for income tax purposes. They are convincing evidence that the involuntary conversion of respondent's property, which bears far less resemblance to a sale or exchange than the transactions embraced in (the) section (of the cited Acts), is not to be placed in one or the other of these categories by implication.

The fact that Congress exercised its legislative prerogative, by subsequently providing that involuntary conversions constituted yet another ambiguous transaction to be treated the same as a sale or exchange, takes nothing from the Flaccus opinion--conversely, it demonstrates the constitutionally prescribed procedure for dealing with such questions.

On the same day as the Flaccus decision, this Court reversed per curiam the Eighth Circuit's Nebraska Bridge Supply decision, involving the same issue as Hammel, based on its Hammel decision. It did not extend the rationale (as the Court below contends) in any respect. It merely applied the same Hammel analysis thereto.

From what this Court said in Hammel and Flaccus, it is evident that the following statement of the Court of Appeals below is a distortion and misapplication of those decisions [page B-23 of Appendix]:

> Based on the Supreme Court's reasoning in Crane, Tufts and Nebraska Bridge Supply, we approve the Tax Court's acceptance of the Commissioner's interpretation that one who abandons property subject to nonrecourse debt receives a relief from the debt obligation when he gives up legal title. Moreover, it is clear that the relief from the debt is what causes the abandonment.

The statement that relief is obtained when one gives up legal title does not apply here because petitioner gave up the

property in 1976 but did not lose legal title until a later year. The statement that the relief from debt is what causes the abandonment is refuted by the facts of the case.

III

Judicial Restraint

This Court's opinion in Hammel was stressed by both courts below as supporting the proposition that this Court had enlarged the scope and application of the term "sale or exchange." Petitioner contends that the opposite is true and that the courts below have misread or misinterpreted the real message.

The basic axiom on the province of the courts was expressed in the decision of United States v. Detroit First National Bank, 234 U.S. 245, 262:

> To depart from the meaning expressed by the words is to alter the statute, to legislate and not to interpret. The responsibility for the justice and wisdom of legislation

> rests with the Congress. It is the province of the courts to construe, not to make laws.

The same message was repeated and amplified in United States v. Byrum, 408 U.S. 125, 135, (1972):

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far reaching consequences. When a principle of tax law requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which readily results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactment, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

IV

Trade or Business Question

The Court of Appeals gave extensive reasons for denying trade or business status to the transaction in issue and also refers to the "clearly erroneous" Rule 52(a). Petitioner's lack of formal

legal training causes uncertainty about dealing with Rule 52(a). However, begging this Court's indulgence, petitioner wants to discuss two aspects of this question.

Petitioner's Business

The property in issue was acquired, managed and abandoned in the course of petitioner's professional occupation as a tax consultant, accountant, real estate broker and property manager. He earned a $4,000 fee from this property and stood to earn a 3% sales commission if the property had ever sold. From his professional office, he negotiated the purchase of the land, collected the rent, paid all expenses, renewed the lease and kept the records for the group of owners. It was definitely part of his professional practice. To say, as the courts below did, that the relationship was too tenuous and conjectural is to ignore the

facts.

Rental Property

The courts have for 50 years or more consistently upheld the principle that the use of property for rental purposes constitutes a trade or business. In cases where the rule did not obtain, the reasons were failure to establish a conversion of a personal residence to rental use, meager evidence of a serious attempt to rent the property where no rentals were received, lack of evidence about values when conversions were made, etc. In decisions where the property was clearly devoted to rental use, the fact that the property was held for sale or was investment property was not deleterious to the finding that rental use qualified as a trade or business.

It appears that this is another area where the Commissioner and the courts are cooperating to "reform" an established

rule without legislative action.

The Court of Appeals here did not mention the source of authority given by the Tax Court for its nonpersuasion that the casual rental converts the property to business use. The authority was Johnson, 19 T.C. 93, where a 22-acre tract was purchased to enhance the sale of a residential estate. During the last 3 of the 5 years held for sale, it was rented for $1 per acre. Despite the trivial amount, the court appeared to be willing to accept business use for those 3 years, but no facts were given concerning the value of the land at the time it was first rented from which to establish gain or loss. Nor did the Appeals Court refer to any other decision supporting the Tax Court's holding. The points made by the Appeals Court / and petitioner's answers:

1. The $1,000 annual rental received was far less than 1% of the $362,132 in-

vestment in the property./ However, only 10% of the total purchase price was ever paid.

2. There were no improvements or definite plans to make any./ There is no difference under the law between improved and unimproved property used for rental purposes as many courts have recognized.

3. Interest expense dwarfs the rental income./ Interest (and taxes) are deductible irrespective of business use and would have to be paid even if the property were not rented. Also, Code section 266 permits those items to be capitalized if properly elected. Furthermore, the courts have not said that a net profit must be realized except with reference to hobby losses.

4. Code section 761(a) permits an organization to be excluded from subchapter K if it is availed of "for investment purposes only and not for the active con-

duct of a trade or business."/ That section actually provides that <u>either</u> the above-quoted purpose <u>or</u> "for the joint production, extraction or use of the property" is eligible for the exclusion. This property qualified under the latter purpose notwithstanding the harmless error on the 761(a) election referring to an "investing partnership."

The names of court decisions cited to the courts below in support of the principle that use of property to produce taxable income from rentals constitutes trade or business use are as follows [citations are listed in the Table of Authorities]:

<u>John Fackler</u>
<u>Leland Hazard</u>
<u>Estate of Ann Gibney</u>
<u>Albert W. Shields</u>
<u>Mary E. Crawford</u>
<u>John E. Good</u>
<u>Anders I. Lagreide</u>
<u>Elli Reiner</u>
<u>Henry L. Stern Trust</u>
<u>Irving R. Stratton</u>
<u>Bernice L. Mercado</u>

Petitioner contends that the reasons given by the courts below for denying business status are not germane and that the decisions may have been unduly influenced by the fact that failure to deny rental use as a business would obviate a decision on the sale or exchange question for which this case may have been targeted.

CONCLUSION

For the reasons set forth above, it is respectfully requested that this Petition for Writ of Certiorari be granted.

/s/ James W. Yarbro
James W. Yarbro, Petitioner

/s/ Mary E. Yarbro
Mary E. Yarbro, Petitioner

1417 Westover Lane
Fort Worth, Texas 76107

Telephone (817) 737-7255

CERTIFICATE OF SERVICE

I do certify that three true and correct copies of the foregoing petition were forwarded by mail, first class postage prepaid to respondent's counsel of record:

Glen L. Archer, Jr.
Assistant Attorney General
Tax Division
Department of Justice
Washington, D.C. 20530

SIGNED this 16th day of October, 1984.

/s/ James W. Yarbro
James W. Yarbro

APPENDIX

APPENDIX "A"

T.C. Memo. 1982-675

UNITED STATES TAX COURT

JAMES W. YARBRO AND MARY E. YARBRO,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 8096-79. Filed Nov. 22, 1982

Roger Norman, for the petitioner.

Rebecca W. Wolfe, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON, Judge: This case was assigned to and heard by Special Trial Judge James M. Gussis pursuant to section 7456(c), Internal Revenue Code of 1954,[1] and Rules 180 and 181 of the Tax Court Rules of Practice and Procedure.[2] The Court agrees with and adopts his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

GUSSIS, Special Trial Judge: Respon-

dent determined a deficiency in petitioners' Federal income taxes for 1976 in the amount of $2,888.89. The issue is whether petitioners realized an ordinary or capital loss when a joint venture in which petitioner James Yarbro was a participant abandoned real property encumbered by a nonrecourse mortgage.

FINDINGS OF FACT

The facts have been substantially stipulated and they are found accordingly.

Petitioners filed a joint income tax return for 1976. Petitioners were residents of Fort Worth, Texas at the time the petition in this case was filed. Since Mary Yarbro is a petitioner herein only by virtue of having filed a joint return for 1976, James Yarbro will hereinafter be referred to as petitioner.

Petitioner is a certified public accountant and real estate broker. He was an Internal Revenue Agent for several

years and then worked for four oil companies as a tax manager and financial vice president. In 1969 petitioner opened his own office as a financial consultant.

The joint venture herein involved was the third real estate joint venture petitioner organized and was known as Yarbro 72-3 Joint Venture (hereinafter referred to as the joint venture). The joint venture was formed in 1972 to acquire approximately 132 acres of undeveloped land in Tarrant County, Texas. Title to the property was held in the name of J. W. Yarbro, trustee. As part of the purchase price the petitioner, as trustee, executed nonrecourse promissory notes secured by deeds of trust. Pursuant to section 761(a), all participants in the joint venture agreed to elect to be excluded from the partnership provisions of the Internal Revenue Code as an unincorporated organization availed of for investment purposes only

and not for the active conduct of trade or business. A statement to the effect was filed with respondent by petitioner, acting as trustee.

Petitioner retained a 10% interest in the joint venture. The other investors included one 50% participant and four 10% participants. About six months after the joint venture was organized petitioner acquired an additional 10% interest when one of the participants decided to dispose of his interest in the joint venture. Petitioner received a fee of $4,000 for his services as trustee and manager of the joint venture property. The joint venture agreement also provided that petitioner was to receive a commission of 3% if the property were sold.

The land was rented for $974 per year for several years and then was increased to about $1,000 per year. Interest payments alone amounted to approximately

$22,000 per year. There were additional obligations for property taxes and insurance. Each participant was required to make a pro rata contribution each year to pay expenses in excess of income.

By November 1976 the fair market value of the property was less than the amount of the nonrecourse mortgage and the City of Fort Worth had proposed a substantial property tax increase. Consequently, the joint venture participants decided not to make the annual interest payment due in November and to abandon the property. Petitioner, as trustee, notified the trustee of the mortgagees that he would not thereafter assert any claim of ownership or attempt to exercise any incident of ownership to the property. The trustee for the mortgagees requested that petitioner, as trustee, voluntarily reconvey the property, but petitioner refused. In June 1977 the mortgagees obtained title to the prop-

erty pursuant to foreclosure proceedings. The joint venture participants received no consideration from the foreclosure.

On his 1976 Federal income tax return petitioner claimed the amount of $10,376 as an ordinary loss under section 165 from the abandonment of the joint venture property.

OPINION

Respondent contends that the loss incurred upon abandonment of the property in 1976 is a long-term capital loss from the sale or exchange of a capital asset subject to the limitations provided in sections 1211 and 1212. To support his claim for an ordinary loss, the petitioner claims the property was not a capital asset because it was either property used in a trade or business or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business and that the phrase "sale or

exchange" does not include an abandonment. We agree with respondent.

Sections 165(a), (c)(1), and (c)(2) allow a deduction for losses incurred in a trade or business and losses incurred in any transaction entered into for profit. These sections are limited by section 165 (f) which provides that losses from sales or exchanges of capital assets shall be allowed only to the extent permitted in sections 1211 and 1212.

Section 1221 defines a capital asset as property held by the taxpayer, but does not include, _inter alia_, real property used in the taxpayer's trade or business or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Petitioner argues that the property (1) was acquired in the ordinary course of his financial consulting and property management business, (2) was used in his trade

or business of renting property, or (3) was purchased with the intent to subdivide and develop the property. The record does not support petitioner's argument that his interest in the joint venture was used in his consulting and property management business. Whether the property was so used is a question of fact. We think petitioner acquired his interest primarily for investment purposes. The nexus between his consulting and property management business and his retention of a joint venture interest is simply too tenuous and conjectural. Petitioner also contends that he was in the trade or business of renting the property. We disagree. We are not persuaded that the casual rental of the undeveloped tract for a nominal annual rental converts the tract into property used in a trade or business within the meaning of the statute. Cf. Johnson v. Commissioner, 19 T.C 93 (1952)

Petitioner also asserts that the property was held primarily for sale to customers in the ordinary course of his trade or business of subdividing property. Petitioner testified that he purchased the joint venture property with the intent to subdivide the land. However, no steps were taken to implement such plan. Moreover, even if such an inchoate intent did in fact exist at one time, it fairly appears on this record that such intent no longer existed in the period in issue. This Court has held that generally it is the purpose for which the property is held at the time of its disposition that determines tax treatment. Daugherty v. Commissioner, 78 T.C. 623, 629 (1982); Biedermann v. Commissioner, 68 T.C. 1, 11 (1977); Eline Realty Company v. Commissioner, 35 T.C. 1, 5 (1960). Accordingly, on this record we conclude that the property was not held primarily for sale to customers

in the ordinary course of business.

Respondent contends that the abandonment of the undeveloped property by the joint venture participants in 1976 constituted a "sale or exchange" within the meaning of sections 1211 and 1222. In Middleton v. Commissioner, 77 T.C. 310 (1981), on appeal (11th Cir. 2/16/82), this Court concluded that the abandonment of undeveloped acreage (which was subject to nonrecourse mortgage liabilities exceeding the fair market value of the acreage) constituted a sale or exchange and hence resulted in capital losses subject to the limitations of section 1211 and 1212. See also Freeland v. Commissioner, 74 T.C. 970 (1980). We believe the Middleton case is indistinguishable from the factual situation here present and consequently we reach the same conclusion here.[3] We therefore hold that as a result of the abandonment of the undeveloped tract in

1976 petitioner incurred a capital loss subject to the limitations of sections 1211 and 1212.

Petitioner also makes certain arguments invoking equitable considerations. This Court does not under the circumstances herein have the jurisdiction to grant such equitable claims. Estate of Rosenberg v. Commissioner, 73 T.C. 1014, 1017 - 1018 (1980). "The Internal Revenue Code, not general equitable principles, is the mainspring of ... [our] jurisdiction." Commissioner v. Gooch Milling and Elevator Co., 320 U.S. 418, 422 (1943).

Decision will be entered for the respondent.

Footnotes

1. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

2. The Court has concluded that the post-trial procedures of Rule 182, Tax Court Rules of Practice and Procedure, are not applicable in

3. Petitioner's efforts on brief to distinguish the Middleton case are unpersuasive. We do not believe that the recent case of Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981), reversing 70 T.C. 756 (1978) certiorari granted May 3, 1982, undermines our holding in the Middleton case. The parties agree that the amount of the loss is $10,376 as claimed on petitioners' 1976 income tax return. The Tufts case, which involved the measure of the loss and not the character thereof, did not involve the issue present here, and we perceive nothing in the Court's opinion which would be applicable here.

UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

JAMES W. YARBRO AND	)	
MARY E. YARBRO,	)	
Petitioners,	)	
	)	
v.	)	Docket No. 8096-79
	)	
COMMISSIONER OF INTERNAL	)	
REVENUE, Respondent.	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, filed November 22, 1982, it is

ORDERED AND DECIDED: That there is a Federal income tax deficiency due from the petitioners for the taxable year 1976 of $2,888.89.

Howard A. Dawson, Jr.
Judge

Entered: Nov. 23, 1982

APPENDIX "B"

James W. YARBRO and Mary E.

Yarbro, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE,

Respondent.

No. 83-4070

United States Court of Appeals,
Fifth Circuit.

July 30, 1984.

Review was sought of Tax Court decision that taxpayers abandonment of real property qualified for capital, rather than ordinary, loss treatment. The Court of Appeals, Brown, Circuit Judge, held that: (1) abandonment of real property subject to nonrecourse debt is a "sale or exchange" for purpose of determining whether a loss is a capital loss, and (2) determination that subject land was a capital asset was not clearly erroneous.

Affirmed.

1. Courts #100(1)

Assuming that Middleton, which held that an abandonment of property subject to nonrecourse debt is a "sale or exchange" resulting in capital loss treatment, was a departure from prior position of the Commissioner of Internal Revenue and the tax court, such departure was not improperly applied retroactively. 26 U.S.C.A. 165 (a,f), 1211, 1212, 1222.

2. Internal Revenue #3041, 3045

Commissioner of Internal Revenue may change an earlier interpretation of the tax law, even if such change is made retroactive in effect and even though a taxpayer may have relied to its detriment on the Commissioner's prior position.

3. Internal Revenue #3038

The Commissioner of Internal Revenue is not required to assert a particular position as soon as the tax law authorizes such an interpretation.

4. Statutes #219(1)

Interpretation of an agency charged with the administration of a statute is entitled to a substantial degree of deference.

5. Internal Revenue #3184

Three things are required to constitute an "exchange," for purpose of capital asset treatment, that being a giving, a receipt and a causal connection between the two. 26 U.S.C.A. 165(a,f), 1211, 1212, 1222.

6. Internal Revenue #3249

One who abandons property subject to a nonrecourse debt receives a relief from the debt obligation when he gives up legal title and, hence, taxpayers' loss resulting from abandonment of unimproved real estate subject to nonrecourse mortgage exceeding the market value was a capital, rather than ordinary, loss. 26 U.S.C.A. 165(a,f), 1211, 1212, 1222.

7. Internal Revenue #3236

While some abandonments of nondepre-

ciable property that bring nothing in return, such as scrapping of absolete equipment, may not be a sale or exchange under regulation allowing an ordinary loss deduction, an abandonment that is deemed to bring in return relief from a nonrecourse debt is a "sale or exchange." 26 U.S.C.A. 165(a,f), 1211, 1212, 1222.

8. Internal Revenue #3249

Finding that real estate was a capital asset was not clearly erroneous notwithstanding that taxpayer, who acquired a real estate broker's license, leased the property for minimal return, as taxpayer acknowledged that one of the primary purposes in acquiring property was to realize an appreciation in value expected to occur as a result of growth of nearby city and shortly after venture, of which taxpayer was a member, was formed all participants elected to be excluded from partnership provisions of Internal Revenue Code. 26

U.S.C.A. 761, 1211, 1222, 1231.

Appeal from the United States Tax Court.

Before BROWN, REAVLEY, and WILLIAMS, Circuit Judges.

JOHN R. BROWN, Circuit Judge:

This case presents the question of whether an individual taxpayer's loss resulting from the abandonment of unimproved real estate subject to a nonrecourse mortgage exceeding the market value is an ordinary loss or a capital loss. Because the Commissioner may change an earlier interpretation to another reasonable interpretation, we affirm the Tax Court's holding that an abandonment of real property subject to nonrecourse debt is a "sale or exchange" for purposes of determining whether a loss is a capital loss.

Facts

James W. Yarbro (Taxpayer)[1] has been a

self-employed financial and tax consultant since 1969. In 1972, he acquired a real estate broker's license. In that year, he formed three joint ventures and negotiated a separate land purchase for each of the ventures. Only the land purchase for the last of the three joint ventures is at issue here.

The venture was formed by Taxpayer, together with five other persons, for the purpose of acquiring about 132 acres of undeveloped land on the northern limits of the city of Fort Worth, Texas. The purchase price was $362,132.08. About 10% was paid in cash, and the balance was covered by four nonrecourse promissory notes secured by deeds of trust on the property. Taxpayer took title to the property as trustee, and under the terms of the joint venture agreement, was responsible for managing the property. For his services as trustee and manager, Taxpayer received a one-time fee

of $4,000. Taxpayer was also entitled to receive a 3% sales commission if the property were sold.

Each participant in the joint venture was required to contribute $4,100 in cash for each ten-percent interest purchased. One investor purchased a 50-percent interest, while the other investors, including taxpayer herein, each purchased a ten-percent interest. About six months after the joint venture was organized, taxpayer bought out one of the other ten-percent investors for $6,150, making his total investment in the joint venture a little over $10,000.

At the time the property was acquired, it was subject to a livestock grazing lease, and during the years the joint venture owned the property (1972 through 1976), it continued to be rented for grazing purposes at a rental of approximately $1,000 per year. The joint venture's only other income during those years was a small amount

of interest. During that same period of time, the joint venture incurred expenses of about $23,000 each year for interest, taxes and insurance. Because these expenses greatly exceeded the income generated by the land, the participants were required to make annual pro-rata contributions to the venture. Taxpayer's contributions were about $4,500 per year.

Taxpayer acknowledged at trial that one of the primary purposes in purchasing the property was the expectation that the property would appreciate in value and that it could be sold at a later date for a substantial profit. Although the possibility of developing the property was considered, no definite development plans were drawn up, no improvements were ever made, and the joint venture participants were never asked to advance any funds for that purpose.[2]

In the summer of 1976, the City of Fort Worth decided to raise the real estate

taxes on the joint venture's property by 435% from $770 per year to approximately $3,350 per year. At about the same time, real estate activity in the area completely dried up. As a consequence, by November of 1976, the property's fair market value had dropped below the face amount of the non-recourse mortgage to which it was subject. When confronted with these facts, the joint venture participants decided to abandon the property and not to pay the real estate taxes for 1976 or the $22,811 annual interest payment for that year. Accordingly, on November 15, 1976, taxpayer, as trustee, notified the Fort Worth National Bank (the trustee of the mortgages) that he was abandoning the property. Although the bank requested taxpayer to reconvey the property to it, taxpayer refused to do so, reasoning that he "had nothing to convey and would have nothing to do... with the property from that point on."

In June, 1977, the bank obtained title to the property pursuant to foreclosure proceedings. None of the joint venture participants received any consideration from the foreclosure sale.

The Tax

On his 1976 federal income tax return, Taxpayer claimed an ordinary loss of $10,-376 from the abandonment of the joint venture property. The Commissioner, however, determined that Taxpayer's loss was not an ordinary loss, but, rather, constituted a long-term capital loss. The Commissioner took the position that Taxpayer's abandonment of the property constituted a "sale or exchange" within the meaning of Sections 1211 and 1222 of the Code. The Commissioner further contended that Taxpayer held his own interest in the land as an investment and not for use in taxpayer's "trade or business" or primarily for sale to customers in the ordinary course of business." Thus,

the Commissioner contended that the abandonment was a "sale or exchange" of a "capital asset."

The Tax Court agreed with the Commissioner's analysis. Determining that Taxpayer acquired his interest in the property "primarily for investment purposes" the Tax Court held that the property was not used in Taxpayer's financial consulting and property management business within the meaning of Section 1231 of the Code. The Tax Court also concluded that the "casual" rental of the land for grazing purposes at a nominal fee did not evidence use of the land in a bona fide rental business, and that the evidence did not support a finding that the land was held primarily for sale to customers in the ordinary course of business. Finally, the Tax Court, following the course charted in Freeland v. Commissioner, 74 T.C. 970 (1980), and Middleton v. Commissioner, 77 T.C. 310 (1981), aff'd

per curiam, 693 F.2d 124 (11th Cir. 1982), held that an abandonment of property constituted a "sale or exchange" for purposes of Code Sections 1211 and 1222.

Statutory Context

Section 165(a) of the Internal Revenue Code of 1954 provides, as a general rule, that taxpayers may deduct "any loss sustained during the taxable year and not compensated for by insurance or otherwise." 26 U.S.C. § 165(a). The application of this general rule, however, is limited by Section 165(f), which provides that "losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212." 26 U.S.C. § 165(f) (emphasis added). Taxpayer, by arguing that the abandonment was not a "sale or exchange," and that the land in the hands of the joint venture was not a "capital asset," seeks to establish that the loss was an ordinary loss. If accepted, this position

would allow Taxpayer to avoid the limitations imposed by §§ 1211 and 1212 on the deduction that may be taken for capital losses.[3]

<u>"Sale or Exchange" by Abandonment</u>

Taxpayer first argues that the Tax Court's decision that the abandonment of property subject to a nonrecourse mortgage is a "sale or exchange" must be rejected because it is a reversal of the position previously taken by the Commissioner, the Tax Court, and other courts. Taxpayer adds that he relied on their earlier positions. In support of this proposition, Taxpayer cites <u>Commissioner v. Hoffman</u>, 117 F.2d 987 (2d Cir. 1941); <u>A. J. Industries v. United States</u>, 503 F.2d 660 (9th Cir. 1974); <u>Blum v. Commissioner</u>, 133 F.2d 447, 448 (2d Cir. 1943); <u>Bickerstaff v. Commissioner</u>, 128 F.2d 366 (5th Cir. 1942); <u>Helvering v. Gordon</u>, 134 F.2d 685 (4th Cir. 1943); <u>Denman v. Brumback</u>, 58 F.2d 128 (6th Cir. 1932).

We point out that in these cases - except for Blum - the issue was not whether an abandonment is a "sale or exchange" for determining whether the loss is capital or ordinary. Instead, these cases decided in which year the loss is appropriately taken. The cases held that the loss was sustained in the year in which the property became worthless and was abandoned, rather than the year in which the taxpayer was technically divested of title. Blum held that the transaction in question was indeed a sale and not an abandonment, and concluded that there was a capital loss. In Commissioner v. Green, 126 F.2d 70 (3d Cir. 1941) and Helvering v. Jones, 120 F.2d 828 (8th Cir. 1941), the courts seem to assume that an abandonment was not a "sale or exchange," but nevertheless held that the loss was a capital loss because the taxpayers' interest in the property were not cut off until the later foreclosure sales, which themselves

are "sales or exchanges." Helvering v. Hammel, 311 U.S. 504, 61 S.Ct. 368, 85 L.Ed. 303 (1941).

[1-3] More recently, the Tax Court, in a case identical in material respects to this case, held that an abandonment of property subject to nonrecourse debt is a "sale or exchange" resulting in capital loss treatment, and the Eleventh Circuit affirmed. Middleton v. Commissioner, 77 T.C. 310 (1981), aff'd, 693 F.2d 124 (11th Cir. 1982). Assuming that Middleton was a departure from the prior position of the Commissioner and the Tax Court, we reject Taxpayer's argument that such a departure is improperly applied retroactively. The Supreme Court has recently held that the Commissioner may change an earlier interpretation of the law, even if such change is made retroactive in effect, and even though a taxpayer may have relied to his detriment upon the Commissioner's prior

position. Dickman v. Commissioner, - U.S. - , 104 S.Ct. 1086, 79 L.Ed. 2d 343 (1984); Dixon v. United States, 381 U.S. 68, 85 S. Ct. 1301, 14 L.Ed. 2d 223 (1965). The Commissioner is not required to assert a particular position as soon as the statute authorizes such an interpretation. Id.

[4] The interpretation of an agency charged with the administration of a statute is entitled to a substantial degree of deference. Aluminum Co. of America v. Central Lincoln Peoples' Utility District, - U.S. - , 104 S.Ct. 2472, 80 L.Ed. 2d - (1984). To uphold an agency's interpretation, "we need not find that its construction is the only reasonable one.... We need only conclude that it is a reasonable interpretation of the relevant provisions." Id., quoting Unemployment Compensation Comm'n v. Aragon, 329 U.S. 143, 153, 67 S. Ct. 245, 250, 91 L.Ed. 136 (1946). As our discussion below indicates, the Commissioner

in Middleton and in this case has given the statutory term "sale or exchange" a reasonable and practical interpretation in light of decisions more recent than the Hoffman, Bickerstaff, Denman line of cases. Moreover, the Tax Court with its own expertise, has accepted that interpretation.

[5] The term "exchange" in its most common, ordinary meaning implies an act of giving one thing in return for another thing regarded as an equivalent. Webster's New International Dictionary (2d ed. 1954). Thus, three things are required: a giving, a receipt, and a causal connection between the two. In the case of abandonment of property subject to nonrecourse debt, the owner gives up legal title to the property. The mortgagee, who has a legal interest in the property, is the beneficiary of this gift, because the mortgagee's interest is no longer subject to the abandoning owner's rights.

In Middleton, as in this case, the taxpayer argued that, because the debt was nonrecourse and he therefore had no personal liability for the debt, he received nothing in exchange for his relinquishment of title. In essence, the argument is that because the taxpayer personally had no obligation to repay the debt, the abandonment could not have relieved him of any obligation. This argument is inconsistent with several Supreme Court decisions.

The Supreme Court has held that regardless of the nonrecourse nature of the debt, the taxpayer does receive a benefit from the disposition of the property; he is relieved of his obligation to pay the debt and taxes and assessments against the property. In Crane v. Commissioner, 331 U.S.1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), the Supreme Court established that, in computing the amount of gain on the disposition, the outstanding debt must be included in

the "amount realized" by the taxpayer, whether the debt is recourse or nonrecourse. However, in that case Mrs. Crane, besides having the vendee take over the loan payments, received $2500 in cash (boot) on the sale. This left open the question of whether the nonrecourse debt would be treated the same as recourse debt in situations where the outstanding debt exceeds the fair market value of the property. In such case, the owner-debtor would not obtain any boot by abandoning the property or transferring it subject to the mortgage.[4]

In Commissioner v. Tufts, - U.S. - , 103 S.Ct. 1826,75 L.Ed.2d 863 (1983), the Supreme Court answered this unanswered question by holding that where the debt exceeded the market value, the entire nonrecourse debt - not just the fair market value - was the "amount realized" by the taxpayer on the disposition of the property. The Tufts court explained:

> We read Crane to have approved the Commissioner's decision to treat a non-recourse mortgage in this context as a true loan.
>
> * * * * * *
>
> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date.
>
> * * * * * *
>
> Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in that property.
>
> * * * * * *
>
> Because there is no difference between recourse and nonrecourse obligations in calculating bases, Crane teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the incumbered property.
>
> * * * * * *
>
> When the obligation is cancelled, the mortgagor is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent....

\- U.S. at - , - , - , 103 S.Ct. at 1831, 1832, 1834, 75 L.Ed.2d at 870, 871, 873.

Although <u>Crane</u> and <u>Tufts</u> concerned the <u>amount</u> of the gain or loss and not the <u>character</u> of the gain or loss, their rationales support the Commissioner's position in the instant case to the extent that

the concept of "amount realized" for computing gain or loss may be equated with the concept of consideration for "sale or exchange" purposes.

Indeed, the Supreme Court in two decisions has followed the same approach of Crane and Tufts in the "sale or exchange" context.

[6] In Helvering v. Hammel, 311 U.S. 504, 61 S.Ct. 368, 85 L.Ed. 303 (1941), and Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666, 61 S.Ct. 827, 85 L.Ed. 1111 (1941), the Court held that there had been a "sale or exchange" and a capital loss even though the taxpayer had received no boot or other consideration, other than relief from a debt. In Hammel, the Court looked to the legislative purpose and history of the capital gain and loss provisions and held that "sale or exchange" included foreclosure sales. The involuntary nature of the

transaction and the lack of any surplus from the sale to be returned to the owner did not make the foreclosure any less a "sale or exchange." Soon after Hammel, the Supreme Court rendered a decision, the relevance of which to the recourse-nonrecourse "sale or exchange" issue was aptly explained by the Seventh Circuit:

> In Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666, 61 S.Ct. 827, 85 L.Ed. 1111 (per curiam), the rationale of Hammel was extended. The taxpayer in Nebraska Bridge Supply owned property on which the real estate taxes were delinquent. The delinquency created no personal liability. The tax lien was thus like a nonrecourse mortgage. Arkansas bid in the property at a tax sale, acquiring it without paying anything. The state was thus like the holder of a nonrecourse mortgage foreclosing on property worth less than the mortgage. The Eighth Circuit had allowed the taxpayer to take an ordinary loss deduction because "[t]he transfer of title to the State is not only involuntary, but is without any consideration moving to the transferor." 115 F.2d 288, 291 (1940). The Supreme Court summarily reversed.

Laport v. Commissioner, 671 F.2d 1028 (7th Cir. 1982). Based on the Supreme Court's

reasoning in Crane, Tufts and Nebraska Bridge Supply, we approve the Tax Court's acceptance of the Commissioner's interpretation that one who abandons property subject to nonrecourse debt receives a relief from the debt obligation when he gives up legal title. Moreover, it is clear that the relief from the debt is what causes the abandonment. It was advantageous, in the view of the Supreme Court, for the taxpayer to relinquish title only because the debt of which he was relieved was greater than the market value. Thus, under the Supreme Court precedents, the abandonment in this case involved a giving in order to receive something in return as the equivalent,[5] and therefore fit within the ordinary meaning of "sale or exchange."

Moreover, an abandonment of property subject to nonrecourse debts has the same practical effect as several other transac-

tions which have each been held to be a "sale or exchange." The Supreme Court has held that an involuntary foreclosure sale of real estate was a "sale or exchange" and the loss a capital loss. Helvering v. Hammel, 311 U.S. 504, 61 S.Ct. 368, 85 L.Ed. 303 (1941). In Nebraska Bridge Supply, the Court held a tax forfeiture to be a "sale or exchange." In Laport v. Commissioner, 671 F.2d 1028 (7th Cir. 1982), the Court held that the taxpayer's conveyance to the mortgagee by quitclaim deed in lieu of foreclosure was a "sale or exchange." In Freeland v. Commissioner, 74 T.C. 970 (1980), the Tax Court held that where the value of land sunk below the amount of a nonrecourse debt and the owner conveyed the land to the mortgagee by quitclaim, there was a "sale or exchange" and an ordinary loss.

The abandonment followed by the mortgagee's foreclosure in this case is the

functional equivalent of the foreclosure sale in Hammel, the tax forfeiture in Nebraska Bridge Supply, and the quitclaims in lieu of foreclosure in Laport and Freeland. In all these transactions, the taxpayer-owner is relieved of his obligation to repay the debt and is relieved of title of the property. Because the mortgagee is legally entitled to recover title to the property in any of these cases, the fact that out of prudence he concludes he must go through foreclosure proceedings to formalize his interest in the land is not a rational basis for altering the character of the gain or loss realized by the taxpayer on the transaction. The differences in these transactions is not a difference in substance, but only in form.

The taxpayer who has decided that he cannot or should not make further payment on the nonrecourse loan can manipulate the form of the change in ownership of the

property simply by either quitclaiming or abandoning the land before the mortgagee forecloses. Thus, the question is "whether a taxpayer can avoid the tax consequences of Hammel and Nebraska Bridge Supply by the simple expedient of [abandoning] the property before the mortgagee can foreclose. The Freeland Court saw no reason, nor do we, to put such a premium on artful timing." Laport v. Commissioner, 671 F.2d at 1033. Cf. Diedrich v. Commissioner, 457 U.S. 191, 102 S.Ct. 2414, 72 L.Ed. 2d 777 (1982) (ignoring form of transaction in favor of the substance of the transaction).

Allowing taxpayers to manipulate the character of their losses from capital to ordinary by hastening to abandon rather than allowing foreclosure would frustrate the congressional purpose to treat capital gains and losses on a parity. As explained by the Supreme Court in Hammel, the quid

pro quo of allowing generous tax treatment on capital gains is the limitation imposed on deductions for capital losses. 311 U. S. at 509-10, 61 S.Ct. at 370-371; 671 F. 2d at 1033; 74 T.C. at 976. Thus, where the taxpayer would be eligible for capital gains treatment upon the sale of property had it appreciated in value, he should not be allowed to avoid the limitations on deductions for capital losses by using an artfully timed abandonment rather than a sale, voluntary reconveyance, or foreclosure. Accordingly, we affirm the Tax Court's holding that Commissioner's interpretation of "sale or exchange" as including an abandonment of property subject to nonrecourse debt is a reasonable one.

No Help from the Regulations

[7] Taxpayer argues that "use of the term 'abandonment' in Regulation 1.165-2, paragraph (a) and the exclusion in paragraph (b) of losses from the 'sale or ex-

change' of property" shows that the regulation recognizes that an abandonment is not a sale or exchange. Section 1.165-2 provides:

> Obsolescence of nondepreciable property
>
> (a) Allowance of deduction. A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.
>
> (b) Exceptions. This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken from section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

1984 Fed. Tax Regs., Vol. I, p. 707.

Initially, we point out that courts have held that the subject of the sentence referring to "act of abandonment" is the proper <u>timing</u> of the deduction for abandonment losses, and not the <u>character</u> of the loss. <u>Laport</u>, 671 F.2d at 1031, n 5; <u>A. J. Industries, Inc. v. United States</u>, 503 F.2d 660, 666-70, n 6, 6b (9th Cir. 1974). Moreover, this regulation is not applicable here, because subsection (b) of the Regulation provides that the Regulation "does not apply to losses sustained upon the sale or exchange of property..." This case falls within the "sale or exchange" exception of subsection (b), for the reasons stated above. Thus our holding is not inconsistent with the implication that taxpayer draws from the use of "abandonment" in subsection (a) and the use of "sale or exchange" in the exception of subsection (b). While some abandonments that bring nothing in return, such as the

scrapping of obsolete equipment, may not be sales or exchanges, cf,e.g., Louisville and Nashville R.R. Co. v. Commissioner, 641 F.2d 435 (6th Cir. 1981); J.B.N. Telephone Co. v. United States, 638 F.2d 227 (10th Cir. 1981), and thus subject to this Regulation, nevertheless, an abandonment that is deemed to bring in return relief from a nonrecourse debt is a sale or exchange. Thus, this case is excepted from Section 1.165-2 by subsection (b), and the allowance by subsection (a) of a deduction for certain other abandonments is not inconsistent with our ruling.

Capital Asset

[8] Taxpayer argues alternatively that even if the abandonment is a sale or exchange, his loss was still ordinary because the land was not a "capital asset" in his hands. 26 U.S.C. § 1221.[6] Specifically, he argues that the land was not held for investment, but instead was "used

in his trade or business" of renting property.

This Court has recently held that our review on the question of a taxpayer's holding purpose is narrowly confined by the Rule 52(a) "clearly erroneous" rule, even though it is an ultimate question of fact in deciding "capital asset" status. Byram v. United States, 705 F.2d 1418 (5th Cir. 1983).[7] "The choice of a standard will determine the outcome of many cases," and this is one such case. 705 F.2d at 1421.

The Tax Court held that Taxpayer was not in the trade or business of renting property, and his interest in the land was not bought or held for that purpose. The Court declared: "We think petitioner acquired his interest primarily for investment purposes.... We are not persuaded that the casual rental converts the tract into property used in a trade or business

within the meaning of the statute." This finding was supported by Taxpayer's testimony acknowledging that one of the primary purposes in purchasing the property was to realize an appreciation in value of the land expected to occur as a result of the growth of nearby Fort Worth. The only rental of the land was for grazing, which brought in approximately $1000 annually. That income covered only a minute part of the partnership's yearly expenses of approximately $71,470 (taxes, insurance, and primarily interest) incurred in owning the land during the same period. Even ignoring these expenses, the $1000 yearly rental would represent a rate of return of far less than 1% on the $362,132 investment in the property. Moreover, there were no improvements made on the land, nor any definite plans to make improvements in the future.

The Tax Court also held that the Tax-

payer's interest in the land was not property used in his trade or business of tax and financial consulting, stating that the connection between the business and the owning of the interest in the land was too tenuous and conjectural. Taxpayer argued that he participated in the venture "to show [to his partner-clients] good faith belief that it was a worthy investment." However, that position means only that he was showing his clients that it was a good investment by choosing it for himself <u>as a good investment</u>. Taxpayer's assertion, therefore, supports the Tax Court's finding that he held the property for investment, rather than for <u>use</u> in his trade or business.

The Tax Court's position is further supported by another admission by the Taxpayer. Shortly after the joint venture was formed, all of the participants elected to be excluded from the partnership

provisions of the Internal Revenue Code pursuant to Section 761(a) of the Code, which provides that an unincorporated organization may elect to be excluded from the partnership provisions of the Code if it is availed of "for investment purposes only and not for the active conduct of a business." On February 15, 1973, taxpayer herein, as trustee, filed the Section 761 election, reciting that the joint venture "qualifies for the election as an investing partnership." Thus, although there was some evidence that Taxpayer's ownership of the property was somewhat related to his consulting business and that some rental income was received, we are not left, after reviewing the record, with a definite and firm conviction that a mistake has been made. United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 541, 92 L.Ed. 746 (1948). Accordingly, the tax court's finding that

the property was a capital asset in taxpayer's hands was not clearly erroneous and must stand.

AFFIRMED.

Footnotes

1. Mary E. Yarbro, Taxpayer's wife, is a party to the suit solely by virtue of having filed a joint federal income tax return with her husband for the year 1976.

2. Other reasons taxpayer gave for purchasing the property were: (1) to further his property management business and to earn a $4,000 management fee, (2) to have the opportunity to earn a three-percent real estate commission if the property were ever sold, (3) to earn rental income, and (4) to become associated with Lawson Ridgeway, a local real estate developer who purchased a 50-percent interest in the joint venture.

3. There are two requirements for the capital gain and loss provisions to be applicable: (1) there must be a "capital asset" or property that is treated like a capital asset under § 1231, and (2) there must be a "sale or exchange." 29 U.S.C. §§ 165(a), (f), 1211, 1212. 8 Standard Federal Tax Reporter paragraph 4717 (CCH 1984). Thus, in order to affirm the holding that the loss was a capital loss, we must affirm that there was both (1) a "sale or exchange," and (2) a "cap-

ital asset."

4. In the now famous footnote 37, the <u>Crane</u> Court observed:

   Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case. Id. at 14, n. 37, 67 S.Ct. at 1054, n. 37, 91 L.Ed. at 1301.

5. The mortgage agreement effectively treated the property and the debt as being equivalent in value.

6. Section 1221 of the Code, in pertinent part provides that a capital asset is "property held by the taxpayer (whether or not connected with his trade or business)." Excluded from the definition of a capital asset, however, is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" and "real property used in his trade or business."

7. For criticism of the <u>Byram</u> holding, see Friedlander, <u>"To Customers" The Forgotten Element in the Characterization of Gains on Sales of Real Property</u>, 39 Tax.L.Rev. 31 (1983).

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 83-4070

Tax Court No. 8096-79

JAMES W. YARBRO and
MARY E. YARBRO,

Petitioners,

versus

COMMISSIONER OF INTERNAL
REVENUE SERVICE,

Respondent.

Appeal from the Decision of the United
States Tax Court

Before BROWN, REAVLEY and WILLIAMS,
Circuit Judges.

J U D G M E N T

This cause came on to be heard on the record on appeal and was argued by petitioner James W. Yarbro and counsel for respondent;

On CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed;

It is FURTHER ORDERED that petitioners

pay to respondent the costs on appeal to be taxed by the Clerk of this Court.

July 30, 1984

ISSUED AS MANDATE:

APPENDIX "C"

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 83-4070

JAMES W. YARBRO and
MARY E. YARBRO,

Petitioners,

versus

COMMISSIONER OF INTERNAL
REVENUE SERVICE,

Respondent.

Appeal from the United States Tax Court

ON SUGGESTION FOR REHEARING EN BANC

(Opinion 07/30/84 , 5 Cir., 198_, ____F.2d

____) (August 30, 1984)

Before BROWN, REAVLEY and WILLIAMS,
Circuit Judges.

PER CURIAM:

(✓) Treating the suggestion for rehearing en banc as a petition for panel rehearing, it is ordered that the petition for panel rehearing is DENIED. No member of the panel nor Judge in regular active service of this Court having requested that the Court be polled on rehearing en banc

(Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

( ) Treating the suggestion for rehearing en banc as a petition for panel rehearing the petition for panel rehearing is DENIED. The judges in regular active service of this Court having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

Thomas M. Reavley
United States Circuit Judge

APPENDIX "D"

UNITED STATES COURT OF APPEALS

FIFTH CIRCUIT

OFFICE OF THE CLERK
600 Camp Street
New Orleans, LA 70130

Gilbert F. Ganucheau
Clerk

September 17, 1984

Mr. James W. Yarbro
Ms. Mary E. Yarbro
1417 Westover Lane
Fort Worth, TX 76107

No. 83-4070 - YARBRO, ET AL v. COMM. OF INTERNAL REVENUE (TC No. 8096-79)

MANDATE STAYED TO AND INCLUDING
October 17, 1984

This Court has this day granted a stay of the issuance of the mandate to the date as shown above. If during the period of the stay there is filed with this office a notice from the Clerk of the Supreme Court that the party who has obtained the stay has filed a petition for the writ in that court, the stay shall continue until final disposition by the Supreme Court. Upon the filing of a copy of an order of the Supreme Court denying the petition for writ of certiorari, the mandate shall issue immediately under Rule 41, FRAP.

Under revised Rule 19.1 of the Supreme

Court, effective June 30, 1980, a request to certify the record prior to action by the Supreme Court on the petition for certiorari should not be made as a matter of course but only when the record is deemed essential to a proper understanding of the case by that court.

A copy of the opinion, judgment, or Rule 47.6 Decision, and denial of rehearing are still required by the Supreme Court to be incorporated as an appendix to your petition. Enclosed are copies of the said documents which have been entered in this cause.

Very truly yours,

GILBERT F. GANUCHEAU,
Clerk

By: H E Adams, Jr.
Deputy Clerk

Enclosures

cc: Mr. Glenn L. Archer, Jr.

(2)

No. 84-612

In the Supreme Court of the United States

OCTOBER TERM, 1984

JAMES W. YARBRO AND MARY E. YARBRO,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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TABLE OF AUTHORITIES

In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-612

JAMES W. YARBRO AND MARY E. YARBRO,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners challenge the court of appeals' holding that certain real estate constituted a "capital asset" and that their abandonment of that real estate to the mortgagee constituted a "sale or exchange," thereby resulting in a capital loss rather than an ordinary loss for tax purposes.

1. In 1972, petitioner James Yarbro[1] and five other individuals formed a joint venture for the purpose of acquiring a parcel of undeveloped land near Fort Worth, Texas. The purchase price was $362,132. About 10% was paid in cash, the balance being covered by nonrecourse promissory notes secured by deeds of trust on the property. Petitioner took title to the property as trustee. Pet. App. B6.

[1] Petitioner Mary Yarbro is married to James and is a party to this case solely by virtue of having filed a joint return with her husband for the tax year at issue.

The property was subject to a livestock grazing lease at the time petitioner's group acquired it, and the joint venturers continued to rent the land for grazing purposes while they owned it. The annual rental income that the joint venture received was about $1,000. Its only other income was a nominal amount of interest. The joint venture incurred expenses of about $23,000 annually, mainly for interest, taxes and insurance in connection with the property. Pet. App. B7-B8.

One of petitioner's primary reasons for buying the property was the expectation that it would appreciate in value and that it could be sold at a later date for a substantial profit (Pet. App. B8). Although the possibility of developing the property was considered, no definite development plans were drawn up, no improvements were ever made, and the joint venture participants were never asked to advance funds for that purpose (*ibid.*). The joint venture's investment nature was confirmed shortly after it acquired the property, when petitioner, in electing to have the joint venture excluded from taxation under the partnership provisions of the Internal Revenue Code,[2] recited that the joint venture was "an investing partnership" (Pet. App. B34). A real estate joint venture generally qualifies for that election only if it is availed of "for investment purposes only and not for the active conduct of a business" (I.R.C. § 761(a)(1)).

In 1976, the City of Fort Worth proposed to increase the real estate taxes on the joint venture's property by 435%. At about the same time, real estate activity in the area became moribund. By November 1976, the property's fair market value had dropped below the face amount of the nonrecourse mortgage that encumbered it. Faced with these facts, the joint venturers de-

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.)

cided to abandon the property rather than pay the 1976 taxes and interest. Petitioner, as trustee, notified the bank which held the mortgage that he was abandoning the realty. The bank requested that he reconvey the property to it, but petitioner refused. Pet. App. B8-B9. In June 1977, the bank obtained title to the property through foreclosure (*id.* at B10).

On his 1976 federal income tax return, petitioner claimed an ordinary loss of $10,376—the amount of his cash investment—on abandonment of the joint venture property (Pet. App. B10). The Commissioner on audit determined that petitioner's loss was not an ordinary loss fully deductible against his income, but rather was a long-term capital loss arising from the sale or exchange of a capital asset. The Tax Court sustained that determination (Pet. App. A1-A13). It found as a fact that petitioner had acquired his interest in the property for investment purposes, rather than for use in a trade or business, and hence that the property was a "capital asset" in his hands (*id.* at A6-A10). And it held that the joint venture's abandonment of the property constituted a "sale or exchange" for federal tax purposes (*id.* at A10-A11). The court of appeals unanimously affirmed (*id.* at B1-B38).

2. Section 165(a) of the Code provides, as a general rule, that taxpayers may deduct "any loss sustained during the taxable year and not compensated for by insurance or otherwise." The application of this general rule, however, is limited by Section 165(f). It provides that losses arising from "sales or exchanges of capital assets" are deductible only as capital losses. Capital losses are subject to limitations on their deductibility that do not apply to ordinary losses.

Petitioner contends (Pet. 40-46) that the joint venture property was not a "capital asset" on the theory that it was used in the trade or business of renting property. The Tax Court resolved this factual question

against petitioner, relying principally on his demonstrated investment objectives and the nominal character of the annual rent (Pet. App. A7-A10). The court of appeals held that the Tax Court's factual findings were not clearly erroneous (*id.* at B31-B35), and there is no basis for further review of that determination.

Petitioner alternatively contends (Pet. 18-41) that, even if the property was a "capital asset," his abandonment of it to the bank was not a "sale or exchange" and hence must generate an ordinary loss. Every court that has squarely addressed this question, however, has held, consistently with the Fifth Circuit here, that the surrender to a mortgagee of property encumbered by nonrecourse debt is a "sale or exchange" for tax purposes. *Middleton* v. *Commissioner*, 693 F.2d 124 (11th Cir. 1982); *LaPort* v. *Commissioner*, 671 F.2d 1028 (7th Cir. 1982); *Freeland* v. *Commissioner*, 74 T.C. 970 (1980). The courts in *LaPort* and *Freeland* concluded that a voluntary conveyance in lieu of foreclosure—effected by a quitclaim deed from the mortgagor to the mortgagee—is a "sale or exchange," notwithstanding that the mortgagor (as here) was not personally liable on the mortgage note and received no consideration other than release from that nonrecourse liability (671 F.2d at 1033-1034; 74 T.C. at 975-982). The court in *Middleton* similarly concluded that a voluntary abandonment by the mortgagor to the mortgagee of property subject to nonrecourse debt is a "sale or exchange" generating a capital loss (693 F.2d at 125).

These courts noted that their holdings were the "logical extension" of this Court's holdings in *Helvering* v. *Hammel*, 311 U.S. 504 (1941), and *Helvering* v. *Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666 (1941), where the Court ruled that the term "sale or exchange" should be broadly construed to encompass involuntary foreclosures by a mortgagee, whether or not the mortgagor is personally liable. See 671 F.2d at 1033; 74 T.C. at 977, 980-981. As the court below observed (Pet. App. B17), the ordinary meaning of "ex-

change" suggests the act of giving one thing for another thing regarded as equivalent. Here, by abandoning the joint venture property, petitioner relinquished all claim to it in return for being relieved of paying the face amount of the mortgage encumbering it. That transaction was plainly an "exchange" in the usual sense of the word.

The court of appeals also noted correctly (Pet. App. B24-B28) that common sense mandates a consistency of results between this case and the other cases discussed above. Practically speaking, the consequences to the delinquent mortgagor are identical regardless of whether the property encumbered by nonrecourse debt is involuntarily foreclosed by the mortgagee (as in *Hammel* and *Nebraska Bridge*), voluntarily conveyed by quitclaim deed to the mortgagee (as in *LaPort* and *Freeland*), or voluntarily abandoned to the mortgagee, who subsequently forecloses without opposition (as in *Middleton* and the instant case). In each situation, the mortgagor receives the same "consideration"—relief from the nonrecourse liability, without more—and there is no reason to treat one form of the transaction as any less a "sale or exchange" than any one of the other forms. Indeed, as the court of appeals emphasized, the tax consequences of a transaction are dictated by its substance and not its form, and petitioner "should not be allowed to avoid the limitations on deductions for capital losses by using an artfully timed abandonment rather than a sale, voluntary reconveyance, or foreclosure" as the mechanism he chooses for relinquishing his interest to the mortgagee. Pet. App. B27. See *Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941); *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938).[3]

[3] Contrary to petitioner's contention (Pet. 18-21), nothing in Treas. Reg. § 1.165-2(a) mandates a different result. That regulation generally provides that "[a] loss incurred * * * from the sudden termination of the usefulness * * * of any non-

Finally, the court of appeals' result is strongly supported by this Court's decision in *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). That case, like this one, involved a taxpayer's transfer of property subject to a nonrecourse mortgage that exceeded the property's fair market value. There, as here, the taxpayer received no appreciable consideration for the transfer other than release from that nonrecourse liability (461 U.S. at 303). This Court held that the taxpayer had to include the entire amount of the nonrecourse debt in his "amount realized" for purposes of computing his gain or loss on the transfer (*id.* at 309-310).

That holding shows the correctness of the Fifth Circuit's holding here. If the nonrecourse debt is part of the taxpayer's "amount realized," obviously, release from that nonrecourse debt must constitute "consideration" to the taxpayer and thus qualify the transaction—be it a voluntary conveyance, foreclosure, or abandonment—as a "sale or exchange." See Pet. App. B20-B21.[4]

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depreciable property * * * where such property is permanently discarded from use * * * shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained." As the court of appeals noted (Pet. App. B29-B30), this regulation by its terms relates only to the *timing* of deductions for an abandonment loss, not to the *character* of the loss as capital or ordinary. See *LaPort*, 671 F.2d at 1031 n.5.

[4] Petitioner seeks to blunt the force of *Tufts* by asserting (Pet. 8-9, 22, 34) that he did not record the nonrecourse mortgage on his books of account or include it in his basis for the property. Petitioner cites no support in the record for this assertion, and we know of none. In any event, the relevant question is not whether petitioner *actually included* the nonrecourse debt in his basis, but whether that nonrecourse debt was *properly to be included* in his basis. See Treas. Reg. § 1.1001-2(a)(3). As this Court noted in *Tufts*, the nonrecourse debt must necessarily become part of the mortgagor's basis, since, the mortgagee not being entitled to it, there is nowhere else for it to go. See 461 U.S. at 308 n.5 (second paragraph).

3. Petitioner errs in asserting (Pet. 27-33) that the circuits are in conflict on the question presented here. Petitioner places primary reliance (*id.* at 27-29) on *Hoffman* v. *Commissioner*, 40 B.T.A. 459 (1939), aff'd per curiam, 117 F.2d 987 (2d Cir. 1941) As the Fifth Circuit observed below (Pet. App. B13-B14), however, the Second Circuit in *Hoffman* did not squarely address the question whether an abandonment constitutes a "sale or exchange" for tax purposes. The same can be said of all the other cases upon which petitioner relies,[5] which either did not address the issue or merely assumed (without deciding) that an abandonment of property results in an ordinary loss.[6] In any event, all these cases were decided before this Court's seminal decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), where the Court first held that relief from nonrecourse indebt-

[5] See Pet. 28-33, citing *Denman* v. *Brumback*, 58 F.2d 128 (6th Cir. 1932); *Bickerstaff* v. *Commissioner*, 128 F.2d 366 (5th Cir. 1942); *Commissioner* v. *Green*, 126 F.2d 70 (3d Cir. 1942); *Helvering* v. *Jones*, 120 F.2d 828 (8th Cir. 1941); and *Blum* v. *Commissioner*, 133 F.2d 447 (2d Cir. 1943).

[6] *Helvering* v. *Flaccus Leather Co.*, 313 U.S. 247 (1941), also cited by petitioner (Pet. 36-38), is not in point. The question there was whether the destruction by fire of fully-depreciated property (buildings, machinery and equipment) used in the taxpayer's trade or business constituted a "sale or exchange" within the meaning of Section 117(d) of the Revenue Act of 1934, 48 Stat. 715. This Court held that the involuntary conversion was not a "sale or exchange," and hence that the insurance proceeds received by the taxpayer were taxable as ordinary income (313 U.S. at 251). In so holding, obviously, the Court expressed no view as to the result that would obtain from the *voluntary* abandonment of *nondepreciable* real estate that is *not* used in the taxpayer's trade or business, the situation presented here. In any event, Congress amended Section 117(d) of the 1934 Revenue Act shortly after *Flaccus Leather* was decided in order to provide for capital gain treatment of involuntary conversions of the sort there involved. See I.R.C. § 1231; H.R. Rep. 2333, 77th Cong., 2d Sess. 96-97 (1942).

edness must be taken into account for tax purposes. Whatever inferences might once have been drawn from *Hoffman* and the other cases petitioner cites, the precedential effect of those decisions was dissipated by *Crane*, which anticipated this Court's decision in *Tufts* and which the Court in *Tufts* found "controlling." See 461 U.S. at 304.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

DECEMBER 1984